STATE OF IOWA

DEPARTMENT OF COMMERCE

UTILITIES BOARD

IN RE: IOWA TELECOMMUNICATIONS SERVICES, INC., d/b/a IOWA TELECOM	DOCKET NO. RPU-02-4 (TF-02-224, TF-02-225, TF-02-226, TF-02-227)

FINAL DECISION AND ORDER

(Issued December 26, 2002)

SYNOPSIS[1]

On May 24, 2002, Iowa Telecom filed a request to increase its residential and business rates by as much as 112 percent to pay for financing costs and to begin installing limited network improvements. The filing was made pursuant to new legislation that permits rate increases under Iowa Telecom's price regulation plan.

In this order, the Board rejects Iowa Telecom's proposed rate increases because they are unreasonable and because Iowa Telecom has not demonstrated that the increased rates will result in tangible benefits to customers. Instead, the Board orders Iowa Telecom to equalize its rates so that all residential customers pay the same rates for the same services and all business customers do the same. The Board grants Iowa Telecom a 3 percent increase on the equalized rates. Finally, the Board grants Iowa Telecom's request for new pricing flexibility that will allow the company to reduce rates to meet competition in specific exchanges.

[1] The purpose of this synopsis is to provide readers a brief summary of the proposed decision. While the synopsis reflects the proposed order, it shall not be considered to limit, define, amend, or otherwise affect in any manner the body of the order, the conclusions of law, the findings of fact, or the ordering clauses.

TABLE OF CONTENTS

PROCEDURAL HISTORY

On May 24, 2002, Iowa Telecommunications Services, Inc., d/b/a Iowa Telecom (Iowa Telecom or Company), filed with the Utilities Board (Board) proposed increases in its prices for basic monthly services, both residential and business. In its cover letter, Iowa Telecom states the filing is made pursuant to Senate File 429, Section 3, of the most recent regular legislative session, now codified as Iowa Code § 476.97(11)"h," which provides as follows:

> h. The board may review a local exchange carrier's operation under this subsection, with notice and an opportunity for hearing, after four years of the carrier's election to be price-regulated. The local exchange carrier, consumer advocate, or any person may propose, and the board may approve, any reasonable modifications to the price-regulation requirements in this subsection as a result of the specific carrier review, with the following limitations:
>
> (1) Such modifications shall not require a reduction in the rates for any basic communications service or a return to rate-base, rate-of-return regulation.
>
> (2) Such proposals for modifications under this paragraph "h" are limited to no more than one every three years.
>
> The board shall approve, or approve subject to modification, a proposal for modification within one hundred eighty days of filing, but for good cause may grant one extension of sixty days, not to exceed a total of two hundred forty days. Reasonable modifications may include increases without offsetting decreases in any rate for basic and nonbasic communications service of the carrier. In reviewing the carrier's proposal, the board shall consider, but not be limited to, potential rate consolidations, the impact of competition or other external factors since election of price regulation, the impact of the proposal on the carrier's ability to attract capital, and the impact of the proposal on the ability

> of the carrier to deploy advanced telecommunications services.

Iowa Telecom proposes to increase rates for basic communications services in order to increase its revenues and equalize its rates throughout Iowa.

As a result of past mergers and transactions, Iowa Telecom has three separate rate zones, formerly served by United Telephone Company of Iowa, Contel of Iowa, Inc., and GTE North Incorporated. The tariffs of the three different operating entities were merged, but Iowa Telecom's predecessor, GTE Midwest Incorporated (GTE Midwest), maintained separate rate zones based upon the old service territories.

In 1995, GTE Midwest filed for price regulation pursuant to Iowa Code § 476.97(11). Then, in 2000 GTE Midwest sold all 296 of its exchanges in Iowa to Iowa Telecom, which assumed the three separate rate zones without change. They are identified in the Company's current tariff as "Iowa Telecom" exchanges, "Iowa Telecom North" exchanges, and "Iowa Telecom Systems" exchanges.[2] Iowa Telecom proposes new rates for basic residential and business communications services in all three territories to arrive at a consolidated rate structure with prices that are higher than it currently charges in any zone.[3] Under Iowa Telecom's proposal, the final increases would be:

[2] Re: GTE Midwest Incorporated and Iowa Telecommunications Services, Inc., Docket No. SPU-99-29.
[3] There are two classes of exceptions. Iowa Telecom does not propose to increase prices in 33 exchanges where it faces competition from another wireline local exchange carrier or in two exchanges it is selling to another local exchange carrier.

Zone and class	Current rate[4]	Final Proposed rate	% increase
Iowa Telecom residential	$14.13	$18.95	34.1%
Iowa Telecom business	$27.87	$31.95	14.6%
North System residential	$12.62	$18.95	50.2%
North System business	$25.22	$31.95	26.7%
IT Systems residential	$ 8.92	$18.95	112.4%
IT Systems business	$15.64	$31.95	104.3%

Iowa Telecom also proposed a temporary rate increase, identified as TF-02-224, pursuant to § 4 of Senate File 429, which requires that the Board grant Iowa Telecom temporary authority to place 75 percent of its requested increase into effect 30 days after the date of filing and continuing while this docket is pending. The temporary rates are collected subject to refund, with interest, of any amounts collected from any customer class which are in excess of the amounts that would have been collected under the rates finally approved by the Board. Iowa Telecom filed a bond in support of its request.

On June 14, 2002, the Iowa Association of Municipal Utilities (IAMU) petitioned to intervene in this docket.

On June 17, 2002, the Board issued an order docketing Iowa Telecom's filing and establishing the procedural schedule for the docket.

On June 21, 2002, the Board issued an order approving the temporary rates filed by Iowa Telecom in this docket for tariff filing TF-02-224.

---

[4] The Iowa Telecom and Iowa Telecom Systems rates shown on this table represent averages calculated from multiple sub-classifications of residential and business rates. "Current rate" refers to Iowa Telecom's rates before the interim rate increase was implemented in this docket.

On July 3, 2002, a group of competitive local exchange carriers (CLECs) consisting of Coon Rapids Municipal Communications Utility, Grundy Center Municipal Communications Utility, Harlan Municipal Utilities, Reinbeck Municipal Telecommunications Utility, Manning Municipal Communication and Television System Utility, and The Community Cable Television Agency of O'Brien County, d/b/a The Community Agency and TCA, on behalf of the Cities of Hartley, Paullina, and Primghar only (collectively, the Municipal CLEC Group), petitioned the Board to intervene in this docket. The petition was granted by order issued July 23, 2002.

On July 5, 2002, the Board issued an order scheduling six consumer comment hearings at various locations in Iowa Telecom's service territory. The Board also approved the petition to intervene filed by the IAMU.

On July 22, 2002, the Consumer Advocate Division of the Department of Justice (Consumer Advocate) and the Municipal CLEC Group filed direct testimony.

On August 5, 2002, Iowa Telecom filed rebuttal testimony.

On September 4, 2002, the Board commenced a hearing to receive the prefiled testimony and exhibits into the evidentiary record and for cross-examination of the prefiled testimony. A three-day hearing was held.

The parties filed briefs on October 4 and 18, 2002.

Issue 1: Are Iowa Telecom's Proposed Rates Reasonable?

A. Summary of Iowa Telecom's Position

Iowa Telecom argues its proposed rate increases are reasonable under the standards of Senate File 429 because they will (1) permit Iowa Telecom to realize substantial rate consolidations, (2) allow the company to receive additional revenue required to offset the impact of competition, (3) have a positive impact on Iowa Telecom's ability to attract capital, and (4) favorably impact the ability of Iowa Telecom to deploy advanced telecommunications services. (Iowa Telecom, Initial Brief, pp. 4-5.) Iowa Telecom believes that the record in this proceeding shows its proposed rate increase satisfies the statutory criteria of § 476.97(11)"h", as modified by Senate File 429. (Iowa Telecom, Initial Brief, p. 6.)

1. Reasonableness

Iowa Telecom offers seven reasons why the Board should find its proposed rate increases reasonable:

1. The Board approved Iowa Telecom's current range= of rates, \$8.92 to \$14.38 for residential and \$15.64 to \$28.92 for business. Iowa Telecom suggests that since the Board deemed the highest of these rates "just and reasonable" as applied to some Iowa Telecom exchanges, they would be presumptively reasonable if applied to other Iowa Telecom exchanges. (Tr. 296.)

2. Senate File 429 eliminated the 2 percent productivity factor, entitling Iowa Telecom to the 2 percent increase it did not receive in 2001. (Tr. 295-96.)

3. Iowa Telecom's proposed rates compare favorably to the range of rates charged for local service in Iowa (average rate: residential - \$12.96, business - \$17.48), Nebraska (average rate: residential - \$16.97, business -

$26.90), Illinois (average rate: residential - $20.15, business - $24.08), and the Dakotas (average rate: residential - $15.72, business - $29.95). (Tr. 298, Iowa Telecom Exs. DMA-1, DMA-2, DMA-3, DMA-4.)

4. Iowa Telecom's proposed residential rates compare favorably to the rate level determinations made by the Nebraska (residential - $17.50) and Illinois (residential - $20.39) commissions in their state universal service fund proceedings. (Tr. 304.)

5. Iowa Telecom's proposed rates are supported by the aggregate price for the Unbundled Network Elements (UNEs) that make up local service for CLECs in Iowa. (Tr. 432-33.)

6. Iowa Telecom's run of the Synthesis Model from the Federal Communications Commission (FCC) produced forward-looking costs of the local loop, for the two federal filing entities of Iowa Telecom, of $54.10 and $54.90. (Tr. 498.)

7. One Iowa Telecom witness conducted an Iowa Telecom-specific statistical analysis that showed a forward-looking cost of providing basic service of at least $39.63. (Tr. 580-81.)

Iowa Telecom concludes that that these points demonstrate that its proposed retail rates are reasonable.

2. Rate Consolidation

Iowa Telecom's rate-increase proposal would consolidate eight different residential and twelve different business rates over a three-year phase-in period in all of its non-competitive exchanges. (Tr. 46.) Iowa Telecom believes this standardization will benefit its customers in the following ways:

1. By standardizing rates into two basic groups, non-competitive and competitive, Iowa Telecom will simplify its pricing structure and be in a better position to explain pricing differentials among customer classes. (Tr. 157.)

2. The rate standardization proposal will benefit many of Iowa Telecom's customers by allowing the company to offer a 20 percent discount to all residential customers who purchase a second line. (Tr. 158.) Currently, this discount is only available to customers in the highest rate zones. (Id.)

3. By consolidating the 12 business rates, Iowa Telecom business customers with multiple locations in Iowa Telecom's service area will pay the same rate at each location (except in competitive exchanges). (Tr. 159.)

4. Besides reducing confusion to customers, rate standardization will also reduce the rate complexity within the company, reduce training time for customer service representatives, lower customer handling time in call centers, improve customer service, and permit the company to mass advertise in non-competitive exchanges, thus reducing marketing costs. (Tr. 160-61.)

Iowa Telecom concludes that, for all of these reasons, rate consolidation will be in its customers' best interests.

3. Impact of Competition And Other External Factors

Iowa Telecom believes the net effect of competitive and external factors has been a drop in its revenue and an inability to make adequate capital expenditures. (Tr. 40.) Iowa Telecom lists these factors as the cause of its revenue shortfall (when comparing actual results to the forecasts Iowa Telecom submitted to the Board in Docket No. SPU-99-29):

1. Iowa Telecom lost a substantial number of access lines in its 33 competitive exchanges (Tr. 172; Confidential Ex. 9). Iowa Telecom states it has lost market share exceeding 80 percent in some of those exchanges. (Tr. 910, 1026-27.)

2. The general economic downturn caused a decrease in access lines. (Tr. 36.)

3. Wireless providers have acquired landline customers. (Tr. 36.)

4. When Iowa Telecom provided customers with clearer bills that listed the services purchased by customers, some customers chose to discontinue certain services that they did not use and may not have realized they were purchasing. (Tr. 173-74.)

5. Higher than anticipated costs for personnel and operations support resulted from problems encountered with the migration of GTE data into Iowa Telecom applications and systems. (Tr. 87, 96.)

6. Higher than anticipated calls to its customer contact centers required an additional 70 employees. (Tr. 88.)

7. The FCC's implementation of the Coalition for Affordable Local and Long Distance Services (CALLS) plan on a mandatory basis reduced Iowa Telecom's interstate access charges. (Tr. 38-39.)

4. Access To Capital Markets

Iowa Telecom believes that the increased revenues from its proposed rate increases will improve the company's earnings before interest, taxes, depreciation, and amortization (EBITDA), which will improve relevant credit ratios, allowing access to a broader range of willing creditors at better terms and conditions. (Tr. 233.) Also, the increased revenue will improve the company's ability to satisfy its debt and preferred stock obligations. Iowa Telecom states these improvements will enhance its ability to attract capital in the future. (Tr. 40-41, 46, 232-33.)

5. Ability To Deploy Advanced Telecommunications Services

Iowa Telecom testified that its current rates for basic local exchange service do not cover the cost of operating the business and do not leave any additional funds for network improvements. (Tr. 291, 405.) Iowa Telecom argued its proposal would provide funds to begin the network improvements required to deploy advanced services. (Tr. 40, 42-43.)

B. Summary of Consumer Advocate Position

1. Reasonableness

Consumer Advocate argues that according to Iowa Code §§ 476.1 and 476.8, rates regulated by the Board pursuant to rate-base, rate-of-return regulation must be "just and reasonable," which means rates based on a determination of the specific utility's costs of providing service for which the rates are to be charged, including a fair profit. A proposal to modify price regulation, in contrast, must be "reasonable" but not necessarily cost-based. Consumer Advocate concludes that the reasonableness of Iowa Telecom's proposed rates is to be judged directly, by consideration of factors other than Iowa Telecom's actual cost of the service. (Consumer Advocate Initial Brief, pp. 4-5.)

Historically, public utility rates were determined to be reasonable when they were based on the actual, prudently-incurred costs of providing services. (Tr. 513-14, 1056.) According to Consumer Advocate, Iowa Telecom did not attempt to demonstrate any relationship between its proposed rates and its actual costs of providing service. Instead, it offered what Iowa Telecom witness Anderson described as "data points for the new thinking on the cost of local service." (Tr. 432.)

Consumer Advocate disagrees with the assertion that the Board's approval of Iowa Telecom's highest rates in some exchanges means those rates are presumptively reasonable in other exchanges. These rates are presumptively reasonable only in the exchanges where they were approved in a rate case and where they are currently being charged. Different and lower rates that were established for the other exchanges are the only "presumptively reasonable" rates for those exchanges. It is misleading and unpersuasive to suggest that the Board has already determined the higher rates to be reasonable in all Iowa Telecom exchanges.

With regard to the proposed 2 percent price increase due to the elimination of the productivity factor by S F 429, Consumer Advocate argues this change should be implemented with the 2002 price plan adjustment, not the 2001 adjustment. The price regulation statute contemplates only annual changes in basic communication service (BCS) rates, as demonstrated by its reference to the annual change in the gross domestic product price index (GDPPI). If the price increase limits imposed by the statute are to have any meaning, the increase opportunities must be limited to one per year. Otherwise, the Company could implement monthly increases based on annual inflation rates and effectively achieve BCS price increases of more than the rate of inflation.

Consumer Advocate also notes that the price regulation specifically limits changes in prices for non-basic communications services (NCS) to 6 percent in any 12-month period. It is unreasonable to interpret the statute to authorize BCS price increases more frequently than NCS price increases. Consumer Advocate concludes Iowa Telecom can only implement BCS price changes on the anniversary of its date of operation under price regulation. (Consumer Advocate Initial Brief, pp. 15-17; Reply Brief, pp. 26-27.)

Consumer Advocate suggests that Iowa Telecom's attempt to justify its proposed rates by comparisons to rates charged by other telephone companies, in Iowa and surrounding states, is too simple to lend any credibility to the proposed rates. A central tenet of telecommunications regulation is that the cost of providing local service can and does vary widely between exchanges and providers. Rate comparisons that make no attempt to identify underlying costs provide no basis for determining the reasonableness of the proposed rates. (Consumer Advocate Initial

Brief, p. 12.) Iowa Telecom's comparisons make no attempt to consider any of the more than 1000 reasons[5] why the cost of providing local service can vary dramatically between companies and geographies. If the Board were to consider such comparisons, the Board would need to abandon its standard for assessing the reasonableness of proposed rates; namely, whether the proposed rates are likely to recover the actual costs of providing service. (Consumer Advocate Reply Brief, p. 3.)

Consumer Advocate takes issue with Iowa Telecom’s comparisons of its proposed rates to the forward-looking costs for local service derived from UNEs, the FCC Synthesis model, and Iowa Telecom's statistical analysis. It is inappropriate and unwise to use forward-looking costs to establish retail rates, as the result will generate revenues in excess of what is necessary to fairly compensate Iowa Telecom for the costs it has actually incurred to provide local service. (Consumer Advocate Reply Brief, p. 4.)

Consumer Advocate disagrees with Iowa Telecom’s attempt to compare its proposed rates with the aggregate rates charged for UNEs. Since federal law requires UNE rates to be based on total long run incremental cost (TELRIC) plus a reasonable allocation of forward-looking common costs, it is unreliable to try and compare these costs with the actual cost of providing service. (Consumer Advocate, Initial Brief, pp. 12-13.)

Consumer Advocate also disagrees with the use of the FCC Synthesis model to provide reliable estimates of the costs of providing local service because of the

[5] As shown by the number of variables in the FCC's Synthesis cost model, see Tr. 527-28.

number of variables associated with the model and, again, because of the use of forward-looking costs. The FCC Synthesis Model does not directly estimate Iowa Telecom's costs, and none of Iowa Telecom's witnesses actually developed a company-specific, forward-looking, cost study model. (Tr. 578-79.)

Consumer Advocate also points out that the Rural Task Force concluded that the costs generated by the Synthesis model are likely to vary widely from reasonable estimates of forward-looking costs and should not be used for determining the forward-looking costs of local service for rural carriers. (Tr. 552-54.)

Consumer Advocate concludes that comparisons to rates charged by other phone companies, to aggregate rates charged for particular collections of UNEs, and to estimates of the forward-looking costs of providing local service generated by the FCC Synthesis model are not apt comparisons and none provides a reasoned or reasonable basis for approving the proposed rates. (Consumer Advocate Initial Brief, p. 12.)

2. Impact of Competition and Other External Factors

Consumer Advocate points out that in response to loss of access lines in the competitive exchanges, Iowa Telecom proposes no rate increases in those exchanges. Iowa Telecom also requests a pricing flexibility provision to enable it to lower basic local service prices in specific exchanges to meet competition. (Tr. 174, 175, 327-30; Ex. 10, Ex. 208.) Consumer Advocate believes that lowering rates might normally be a rational response to competition, but does not believe residential rate increases of 31.8 to 112.4 percent and business rate increases of 10.5 to 104.3

percent in the monopoly exchanges are an appropriate part of that rational response. (Ex. 18, pp. 1, 2, 11, 12.) Consumer Advocate characterizes this as classic monopoly behavior: Compete where necessary and charge captive customers what the market will bear. It is unreasonable to dramatically raise prices in monopoly exchanges to make up for revenue foregone in exchanges with alternative providers. In fact, the Board-approved pricing flexibility provisions of the Qwest and Frontier price plans explicitly prohibits this behavior. (Consumer Advocate, Initial Brief, p. 6.) Consumer Advocate contends that by relying on the impact of competition in 33 exchanges as justification for dramatic price increases in all monopoly exchanges, Iowa Telecom is seeking to recover revenue it will not collect from its own customers in those exchanges as well as revenue foregone by losing customers to competitors. (Consumer Advocate, Initial Brief, p. 7.)

Consumer Advocate states it is not clear whether Iowa Telecom offered evidence of the financial impact of the FCC's CALLS plan as justification for its proposed price increases or merely to account for a portion of the disparity between its actual financial results and financial projections presented to the Board in Docket No. SPU-99-29. However, Consumer Advocate does not believe the record establishes that it would be reasonable to dramatically increase intrastate-jurisdictional rates to offset the implementation of the CALLS plan, which affected interstate rates. (Consumer Advocate, Initial Brief, p. 7.)

3. Access To Capital Markets

Consumer Advocate agrees that if one assumes all else is unchanged, it is generally true that additional revenue will tend to enhance a firm's ability to attract capital. However, the Board should also consider Iowa Telecom's overall financial condition, obligations, needs, and prospects. (Consumer Advocate, Initial Brief, pp. 7-8.) Consumer Advocate concludes that Iowa Telecom's financial condition is not good. The evidence demonstrates that Iowa Telecom's current financial position is the product of several factors, but that the most significant factors are or were largely within the control of and the responsibility of the Company's owners – not its customers, its competitors, its regulators, or others. (Consumer Advocate, Initial Brief, p. 8.)

Consumer Advocate points out that Iowa Telecom's Vice President and Chief Financial Officer Knock identified significant variances between Iowa Telecom's original forecasted and actual financial results for the fiscal year ended June 30, 2001. (Tr. 35-38, 224-25; Ex. 16.) These significant variances indicate the purchasers of GTE's Iowa exchanges lacked important knowledge about the assets they were purchasing and the markets they would be serving. (Consumer Advocate, Initial Brief, p. 8.) The impact of paying more than net book value for GTE's Iowa exchanges (Ex. 12, p. 8), combined with a capitalization scheme the Board characterized as having a "relatively higher degree of financial risk" in comparison to a typical Iowa utility,[6] are far more important factors in the company's current financial condition than the inaccuracy of Iowa Telecom’s past projections. (Consumer Advocate Initial Brief, p. 9.)

Consumer Advocate notes that Iowa Telecom’s total investment and capitalization combine to impose a net interest expense that represents an unusually high proportion of its annual revenues. (Ex. 12, p. 3.) In fact, Iowa Telecom's interest expense per access line per month is very close to its proposed residential rate (Tr. 270), meaning that if the Board were to approve the proposed increase, nearly all of a residential customer's basic monthly payment would go to interest payments.

Consumer Advocate states that under these circumstances, Iowa Telecom cannot reasonably assume any additional debt capital and if it did, it would be unlikely to be offered on reasonable terms. Consumer Advocate mentions that the Board, in allowing Iowa Telecom’s acquisition of GTE’s Iowa exchanges, expressed some confidence that the owners of Iowa Telecom would be willing to provide additional capital funds if necessary,[7] based on Iowa Telecom's sworn testimony in that proceeding.

Consumer Advocate concludes that Iowa Telecom’s proposal will not have a significant impact on its ability to attract capital and, therefore, does not support a finding that the proposal is reasonable. (Consumer Advocate Initial Brief, p. 10.)

---

[6] *GTE Midwest Incorporated and Iowa Telecommunications Services, Inc*., Docket No. SPU-99-29, slip op. 6 (IUB April 13, 2000).

4. Ability to Deploy Advanced Telecommunications Services

Iowa Telecom, in response to a Board order, filed its 2002 Network Improvement Plan on June 27, 2002. At consumer comment hearings and on its Web site, Iowa Telecom promoted the plan as a means of providing enhanced services throughout its service territories. (Ex. 207.) However, Iowa Telecom's projected use of the proceeds from its proposed rate increases shows that in 2003 only $2.5 million would be available for network improvements. The remainder would be needed to pay debt. While the amounts available for capital improvements are projected to increase in 2004 and 2005, the bulk of the increase would still go to debt and preferred stock. (Ex. 20.) (Consumer Advocate Initial Brief, p. 11.)

Consumer Advocate concludes that Iowa Telecom's obligations for financing costs stand as a formidable barrier and preclude significant network investment, despite the magnitude of the proposed rate increases. (Consumer Advocate, Initial Brief, p. 11; Reply Brief, p. 6.)

C. Board Analysis

1. Reasonableness

Iowa Telecom did not engage in cost analysis to determine the Company's cost of providing basic communications services. Instead, its officers determined a level of revenue that would be acceptable to its creditors and enhance its earnings ratios, in order to avoid defaulting on its debt covenants. (Tr. 41.) Iowa Telecom

[7] *GTE Midwest Incorporated and Iowa Telecommunications Services, Inc*., Docket No. SPU-99-29, slip op. 7 (IUB April 13, 2000).

proposes to accomplish this by raising the local service rates of its residential and business customers, in non-competitive exchanges only, by as much as 112 percent and 104 percent, respectively. In other words, it appears Iowa Telecom determined how much additional revenue it required and then backed into the resulting rate increases.

Iowa Telecom offers several reasons why it believes its proposal is reasonable. However, the record leads to the conclusion that the company's overall proposal to increase rates is not reasonable.

When Iowa Telecom purchased the Iowa assets of GTE, it paid a net purchase price that was substantially in excess of the book value of those assets.[8] Iowa Telecom projected that its revenues would be sufficient to cover its costs, including the cost of debt, but those projections have not proven to be accurate. Iowa Telecom is attempting, with this proposal, to shift the burden of its financial problems from its investors to its customers. If Iowa Telecom operated in a competitive market, it would not be able to retain its customer base by raising rates in the manner proposed. This is borne out by the fact that Iowa Telecom has proposed to NOT raise rates in exchanges where competition currently exists.

Iowa Telecom is essentially asking the Board to bail it out of its financial difficulties at the expense of customers who have few, if any, alternative choices for basic communications services. It is not reasonable to make a captive market pay

[8] Iowa Telecom filed much of the specific financial information in this case as confidential, pursuant to 199 IAC 1.9, so this order cannot always include specific numbers even when the record contains that information.

for a company’s inaccurate forecasting or its decision to take on a particular debt load. The seven arguments offered by Iowa Telecom in support of its proposed rates are not sufficient to require a different conclusion.

First, the Board agrees with Consumer Advocate that it is unreasonable to conclude that rates previously approved by the Board for some exchanges are automatically reasonable for Iowa Telecom customers in other exchanges. The rates that were approved for the "Iowa Telecom" rate zone, for example, were originally based on the cost to provide service to customers in those specific exchanges; they do not automatically constitute reasonable rates for customers in the other rate zones.

Second, the Board also agrees with Consumer Advocate that § 479.97(11), the price regulation statute, should be interpreted to limit BCS price increase opportunities to one per year. It would be inconsistent to use an annual inflation adjustment more often than once per annum. Any other interpretation should be rejected.

Moreover, the Board finds that Iowa Telecom's proposed adjustment to eliminate the 2 percent productivity factor in the 2001 BCS price adjustment would give retroactive effect to Senate File 429. However, Senate File 429 does not provide that it should be given retroactive effect. This legislation made substantive changes in Iowa Code § 476.97(11), and substantive law changes should only be applied prospectively. Iowa Code § 4.5; Frideres v. Schiltz, 540 N.W.2d 261, 264 (Iowa 1995). Iowa Telecom is proposing to go back and re-calculate the BCS price changes it implemented in 2001, based upon a subsequent change in the law. While that may not be retroactive ratemaking, it is still proposing to give retroactive effect to the statute by using the change in the law to justify re-calculating the prices set in 2001 and therefore must be rejected.

In its reply brief, Iowa Telecom cites Re: Marriage of Griffin, 570 N.W.2d 258 (Iowa Ct. App. 1997) for an explanation of the manner in which a statute should be applied to conduct before and after the effective date of the statute. In that case, the General Assembly amended § 598.21(5A) to provide that a divorced parent may be obligated to support a child past the age of 18 under certain circumstances. One of the Griffin children was attending college when the amendment became effective, raising the issue of how the amendment would apply. The Court held that a parent's support obligations could be modified to include a portion of the child's college expenses after the effective date of the amendment, beginning with the next school year. This is consistent with the Board's application of Senate File 429 in this case; the change in the price adjustment formula will apply to Iowa Telecom's next annual price adjustment proceeding, just like the child support changes in Griffin.

Third, the Board rejects Iowa Telecom's comparison of its proposed Iowa rates with those of neighboring states and other carriers. Other states have different economies, different customer bases, and different costs to serve. As a test of reasonableness, a comparison to out-of-state rates is not relevant without additional evidence that the rates, the services, and all other relevant circumstances are truly comparable. That evidence is lacking in this case.

As its fourth argument, Iowa Telecom offers an in-state comparison of carrier rates. Such a comparison may be more appropriate than the other-state comparison, but in this case it does not support Iowa Telecom's proposed rates. The average residential rate for the companies Iowa Telecom chose to include is $12.96. This is very close to the approximate revenue-neutral rate of $12.39 for Iowa Telecom's residential service, as calculated from the information available in this record.[9] No evidence was offered to show that Iowa Telecom's rates should be significantly different from the Iowa average.

Fifth, the Board finds that the use of UNE prices, or any model utilizing forward-looking costs, is not appropriate for setting retail prices for local service, at least as presented in this case. As Consumer Advocate points out, if the Board were to use forward-looking cost models to set retail rates, then the resulting rates would no longer reflect the actual, prudently-incurred cost of providing service to customers. It is possible that forward-looking cost models may be useful for retail rate setting in the future, but this record does not contain any evidence demonstrating that they are useful at this time and for this purpose.

In particular, Iowa Telecom’s use of the FCC Synthesis Model to provide a "data point" for consideration of reasonableness is of questionable usefulness. The model was not designed to calculate retail rates. (Tr. 527-80.) The fact that only

---

[9] Using Iowa Telecom's Exhibit CAK-7, under the "current" heading, the Board took each of the eight residential service-individual line (R1) monthly rates and multiplied it by the number of units for each, giving a monthly income. These monthly income figures were totaled and divided by the total number of units. This gives a rough revenue-neutral rate for residential primary line. The same method was used to calculate the business service-individual line (B1) revenue-neutral rate.

default inputs were used makes the application of the model even more tenuous. The Rural Task Force for Universal Service, of which Iowa Telecom's own witness was a member, deemed the Synthesis Model unsatisfactory for use in determining forward-looking costs for local service for rural carriers such as Iowa Telecom. (Tr. 549–55.)

As far as Iowa Telecom's sixth argument is concerned, the Iowa-specific statistical analysis yielded a cost for providing basic service of $ 39.63 (Tr. 580-81), while IAMU's witness, using a variation of the same method, arrived at a figure of $82. (Tr. 843.) This wide range of results does not provide a useful data point for Iowa Telecom to defend its proposed rates as being reasonable; instead, it indicates the entire statistical analysis is so sensitive to its inputs and assumptions that it could be used to support almost any position. (Tr. 503, 535, 579, 748.)

Overall, the Board finds that Iowa Telecom has failed to show that its proposed rates would be reasonable. The comparisons offered by Iowa Telecom are not sufficient to justify residential rate increases of as much as 112 percent or business rate increases of over 104 percent. Iowa Telecom's proposed rate increases will be rejected.

2. Rate Consolidation

Iowa Telecom proposes to consolidate eight residential rates and twelve business rates into one residential rate and one business rate in its non-competitive exchanges. (Iowa Telecom Initial Brief, pp. 10-11.) The record establishes that rate consolidation will reduce confusion to both residential and business customers, result in shorter customer handling times in call centers, reduce the training time for new customer service representatives, and allow for mass advertising in non-competitive exchanges. (Iowa Telecom Initial Brief, pp. 11-12.)

The Board agrees that standardizing rates would be beneficial to both Iowa Telecom and its customers and, therefore, believes that Iowa Telecom should pursue rate consolidation. However, as shown in the preceding paragraphs, it would not be reasonable to consolidate Iowa Telecom's rates at the levels proposed by Iowa Telecom. Instead, consolidation should be done in a revenue-neutral manner. As previously described, data provided by Iowa Telecom in this record shows that $12.39 is a good approximation of a revenue-neutral, reasonable residential rate for basic local service. Similar calculations show that a revenue-neutral business rate would be approximately $23.95.

Iowa Code § 476.97(11)"h"(1) states that any modification to the company's price regulation requirements "shall not require a reduction in the rates for any basic communications service . . . ." If this were interpreted to mean that no rates can be reduced by Board order, then the Board could not order Iowa Telecom to rebalance its rates in a revenue-neutral manner, since that would require that some rates be reduced to offset increases in other rates. However, the Board believes a better interpretation of the statute is that revenue-neutral rebalancing is not prohibited because no overall revenue reduction will take place. This is true because the purpose of the statutory provision is to prevent a forced revenue reduction to the utility.

Thus, Iowa Telecom currently collects a certain amount of gross revenue from its residential customers each year, based on eight separate residential prices. A revenue-neutral adjustment of these prices will not reduce Iowa Telecom's total revenues from its residential customers and, therefore, will not "require a reduction in the rates for [residential] basic communications service" from the Company's point of view. Moreover, the Board will allow Iowa Telecom a 3 percent rate increase on the rebalanced rates, to cover the costs of rate consolidation and any incidental revenue losses that may be associated with consolidation. This increase will be in addition to the statutory inflation adjustment of 1.06 percent filed by Iowa Telecom on November 11, 2002, on an informational basis.

Finally, the Board notes that the consolidated rates used in this order ($12.39 residential, $23.95 business) are based on a record that was not filed for the express purpose of making these calculations. As such, it is possible the data used may not be the best or most complete for this particular purpose. Therefore, the Board will direct Iowa Telecom to file its own calculations of a revenue-neutral rate consolidation of all rates that currently differ among the rate zones (other than Extended Area Service rates or similar exchange-based rates), with all supporting workpapers, within 30 days of the date of this order, for review and approval. The calculations should be performed without the 3 percent revenue increase for the consolidated rates or the 1.06 percent increase for BCS services, which should then be added as successive calculations.

3. Impact of Competition And Other External Factors

In its testimony, Iowa Telecom lists a number of competitive and external factors it holds responsible for the Company's failure to achieve the financial projections it submitted in Docket No. SPU-99-29. Those factors include loss of access lines, a general economic downturn, changes in customer billing, higher than expected costs, and the FCC's CALLS plan. Each of those factors will be discussed below.

While it is true that Iowa Telecom suffered a loss of access lines in 33 exchanges where competitive providers entered the market, it is also true that this was the vision of the federal Telecommunications Act of 1996 (the Act). The general premise of the Act is to promote competition in the telecommunications industry, especially in markets dominated by one provider. Iowa Telecom found itself vulnerable to competition because it purchased an aged, out-of-date network (Tr. 40) and took on a substantial amount of new debt in the process. (Iowa Telecom Confidential Ex. CAK-1, p. 8) These two factors left Iowa Telecom vulnerable to competition and unable to respond with advanced telecommunication services.

Iowa Telecom also points to a change in its customer billing, higher than expected costs for personnel and operations support, and higher than expected call levels to its customer contact centers, as external factors the Board should consider. However, these factors are internal to Iowa Telecom, are the results of the Company's own business decisions, and should not be considered as external factors meriting a raise in customer rates.

Further, Iowa Telecom blames the general economic downturn and competition from wireless service providers for additional loss of access lines. These events may have been contributing factors in Iowa Telecom's failure to perform as it predicted in Docket No. SPU-99-29, but they are factors that all telecommunications providers are subject to and are not unique to Iowa Telecom. Moreover, they were foreseeable possibilities at the time Iowa Telecom closed its purchase of GTE's Iowa assets[10] and prudent management should have planned for these contingencies.

Finally, Iowa Telecom points to the FCC's implementation of the CALLS plan, which lowered its interstate access charges as another external factor reducing its revenue. In its November 26, 2001, petition for forbearance to the FCC, Iowa Telecom states, "The lack of time, together with Iowa Telecom's then lack of experience and expertise, precluded Iowa Telecom from making a meaningful election decision." (Iowa Telecom, Ex. 34, p. iii.) This may be true, but the fact that Iowa Telecom may not be maximizing its interstate revenues has nothing to do with the Company's intrastate revenues. There is no basis in this record for increasing Iowa Telecom's local rates, which are jurisdictionally intrastate, to make up for an alleged shortfall in its interstate revenues.

It is clear that Iowa Telecom did not make accurate financial forecasts in connection with its purchase of GTE's Iowa assets. By itself, this is not surprising;

[10] In Docket No. SPU-99-29, the Board specifically asked Iowa Telecom witnesses about the possibility of an economic downturn and about the possible loss of customer accounts due to competition and was assured that Iowa Telecom had factored these possibilities into its projections. (Transcript of February 8, 2000, hearing in Docket No. SPU-99-29, pp. 110, 341-42, and 373-74, hereinafter referred to as "SPU-99-29, Tr. 110, 341-42, and 373-74.")

the very nature of forecasts is such that they will seldom be entirely accurate. That is why prudent management requires a certain level of contingency planning, to give the company enough flexibility to weather adverse events using its own resources, rather than relying on a substantial rate increase to customers in non-competitive exchanges. In Docket No. SPU-99-29, the Board attempted to ascertain whether Iowa Telecom had allowed for such contingencies and was consistently and repeatedly assured that it had. The Iowa Telecom witnesses testified, under oath, that if the company failed to meet its forecasts, things would "work out," that the company was "confident in the numbers we have," that the numbers were "prepared on a conservative basis," that there were "no major risks at all in this venture," and that the Company "will be very, very financially sound." (SPU-99-29, Tr. 110, 333, 339, 343, 363, 372, 374, 383.) On the basis of this record, the Board understood that Iowa Telecom had planned for the foreseeable contingencies and a reasonable level of unexpected events.

4. Access To Capital Markets

According to Iowa Telecom, the only capital-related issue relevant to this docket is whether the proposed rate increases will improve Iowa Telecom’s ability to attract capital. (Iowa Telecom, Reply Brief, p. 7.) Iowa Telecom’s position is that its proposed rate increase will result in additional revenues that will improve its ability to attract capital, so this factor is satisfied. (Tr. 40-41, 46, 232-33.)

Iowa Telecom’s analysis is overly-simplistic. Under the Company's interpretation, the Board would never need to consider this factor, since any revenue increase would be beneficial and this statutory factor would be meaningless. Instead, this factor requires that the Board consider the utility's financial condition, obligations, needs, and prospects to determine if increasing rates will have a significant and beneficial effect on the company's ability to attract additional capital, an effect that is worth the extra cost to customers.

It is clear in the record that the additional revenues from Iowa Telecom's proposed rate increases will primarily be used to fund current financial obligations. A portion of these revenues will be used to pay costs related to the amendments already made to the credit agreement.[11] The total amount of the proposed additional revenues over the next three years is $41,536,000. Of this amount, less than half is projected to be available to maintain and improve Iowa Telecom's network. The remaining amount is used to support Iowa Telecom's debt and preferred stock obligations. Even so, Iowa Telecom would only meet a portion of its preferred debt dividend obligation during the time period 2004 through 2008, after which a substantial additional loan would be required. (Confidential Ex. CAK-9; Iowa Telecom's Second Response to the Board's Request for Additional Information.)

The question the Board must consider is whether the proposed rate increase would be enough to make a definite impact on Iowa Telecom's ability to attract capital. Stated differently, the question is: What level would the rates need to be in order for Iowa Telecom to be able to pay its current financial obligations, maintain its

[11] Iowa Telecom has already needed to amend its credit agreement three times. With the exception of the first amendment, the amendments were needed to adjust ratios that were dependent on Iowa Telecom's EBITDA.

existing system, strengthen its financial position, and make the network investments proposed in Iowa Telecom's Network Improvement Plan. Even Iowa Telecom's projections demonstrate that the proposed rate increases will not produce sufficient additional revenue to achieve all of these goals.

If the increase would add to the common equity portion of the balance sheet and strengthen Iowa Telecom’s financial position, it might be better able to attract any needed capital, but it is clear that after paying its debt and preferred stock obligations, little will be left to strengthen the balance sheet. Even this assumes Iowa Telecom's projections are accurate. If Iowa Telecom's projections are not realized, Iowa Telecom’s ability to attract capital would be even more severely limited.

In its decision in Docket No. SPU-99-29, the Board recognized that the financial entities investing in Iowa Telecom could not guarantee the accuracy of their projections. (Order of April 13, 2000, p. 7.) In Iowa Telecom’s first filing of additional information in this docket, it provided the assumptions used to prepare its revenue projections for the next several years. In its second filing of additional information, Iowa Telecom provided justification for its assumptions. Again, the Board does not expect Iowa Telecom to guarantee the accuracy of its forecasts, but the record in this case indicates the current forecasts may not be based on reasonable assumptions.

For example, Iowa Telecom assumes that the number of access lines it serves will increase each year after 2002, despite its recent losses in this area. When the Board asked Iowa Telecom's witness why he assumed that future access line losses would occur only in 2002, the first year of the proposed phase-in period, rather than in later years when rates would be highest, the witness's response was "One of the principal reasons was that we expected that the initial increase to be enough for folks to perhaps cancel second lines and in some instances just leave the system; and, again, this was done with better information at a later time." (Tr. 254.) Iowa Telecom did not make this "better information" available to the Board.

A review of the record does not support these assumptions. Iowa Telecom is proposing to raise rates over a two- or three-year period, yet it is assuming that any loss in access lines will occur only in the first year. If demand for local exchange service has any elasticity at all, then it is more reasonable to assume there will be additional access line losses each time rates are increased during the phase-in period. Additionally, if the Company's higher rates were approved, it is likely Iowa Telecom would see new competition in some existing monopoly exchanges, leading to loss of additional lines. The Company's apparent failure to recognize the full potential effect of competition is reminiscent of its original projections in Docket No. SPU-99-29, where it claimed it considered competition in making its projections, but it is now coming before this Board and saying that it experienced an unexpected loss of access lines after it had projected growth. Based on the Company's track record and common sense, the Board cannot accept Iowa Telecom's projection that the number of access lines it serves will begin to increase in 2003 and continue to increase in subsequent years.

Iowa Telecom also projects that revenues from non-basic communications services will increase at a particular rate, based on the 6 percent increases allowed by the price regulation statute. However, it is at least as likely that customers will significantly reduce their demand for non-basic services during an economic downturn or when their basic rates are increased significantly, in order to reduce their overall telephone bill, such that it may not be possible for Iowa Telecom to raise rates for non-basic services without actually reducing revenues. Therefore, this Company assumption is also suspect.

Iowa Telecom's projections in this docket also forecast that the number of access minutes per access line will grow at a particular rate, based on Iowa Telecom's historical average access minutes per access line and general industry access minute data. (Second Submission of Additional Information, Response to Question # 4.) However, evidence in the record suggests otherwise. On September 5, 2002, the Board issued an order taking official notice of a National Exchange Carriers Association (NECA) report entitled “Minutes Of Use Data/Summary of NECA Total Pool Results.” This report, for the time period April 1, 2001, to March 31, 2002, shows a decrease in the minutes of use per access line for Iowa Telecom's group and the industry in general, rather than an increase. This data appears to be more consistent with general industry trends and common sense, as cellular calling plans, electronic mail, voice-over-internet protocol calls, and other substitutes are tending to reduce access minutes. Iowa Telecom's projected increases seem unlikely.

Finally, the Board cannot ignore the fact that Iowa Telecom's financial projections in Docket No. SPU-99-29 have proven to be unrealistic and extremely optimistic, rather than "conservative." It is the Company's failure to come close to achieving its forecasts, combined with its highly-leveraged capital structure, that has caused the Company's current financial distress.

In its reply brief, Iowa Telecom points out that in Docket No. SPU-99-29, the Board concluded “that the ability of ITS to attract capital on reasonable terms and its ability to maintain a reasonable capital structure is not unreasonably impaired by the proposed transaction.” (Iowa Telecom, Reply Brief, p. 9, citing the Board's order of April 13, 2000, p. 8.) Iowa Telecom implies that the Board's approval of its capital structure in that earlier docket has some bearing on the Company's current need for additional revenue. Nothing could be further from the truth.

Iowa Telecom quotes only part of the Board's finding from the April 13, 2000, order. When the entire statement is considered, it is clear that the Board was very concerned about Iowa Telecom's initial capital structure and approved it only on the basis of Iowa Telecom's sworn testimony:

> Overall, the Board concludes that, if the Board were only looking at the initial financial position of ITS and this specific factor, there would be a serious question whether ITS will be able to attract capital on reasonable terms if additional capital is required in the near future. However, the Board will also consider ITS’s financial projections, which indicate ITS is unlikely to need additional capital in the near future and that ITS’s capital structure will improve each year. Furthermore, the Board will not ignore the fact that ITS is backed by two healthy investors. When all of these facts are considered, the Board concludes that the ability of ITS to attract capital on reasonable terms and its ability to maintain a reasonable capital structure is not unreasonably impaired by the proposed transaction.

(Order at p. 8.) In Docket No. SPU-99-29, the Board had to rely on the testimony of the Iowa Telecom witnesses. At hearing, the Board asked the Company's witnesses their opinion of Iowa Telecom's ability to ride out economic downturns and what the Company could do if the projections fell short. Those witnesses consistently assured the Board that the Company's financial projections were conservative and that Iowa Telecom would be a financially-strong company. For example, one company witness testified that "ITS will be very, very financially sound and capable of performing and meeting all of its obligations." (SPU-99-29, Tr. 108-09.) When asked whether he was fully satisfied that the Company would be able to handle economic downturns and still increase revenues in order to meet its financial targets, the same witness answered "yes." (SPU-99-29, Tr. 109.)

Another Company witness testified in the 2000 hearing that he had no great concerns regarding the downside for this Company and that he did not see any major risks at all in this venture. (SPU-99-29, Tr. 371.) The witness further testified that the Company's capital needs had already been arranged and no additional capital was expected to be required, as all future capital needs would be internally generated. (SPU-99-29, Tr. 351.)

Iowa Telecom also offered testimony in 2000 that its investors would have an incentive to invest additional funds, if necessary, in order to see Iowa Telecom succeed. Yet another Company witness testified that he could not commit that the equity investors would provide technological and financial support to ITS, but he believed they had been very supportive and planned to continue to be so down the road. (SPU-99-29, Tr. 178-79.) Another Iowa Telecom witness testified that " . . . if additional funds were needed for the operation of the company, it makes good business sense for companies to provide additional dollars as the case may be. * * * Both [equity investors] are in this for the long haul, and we want to make this company work, so I would think that these companies would contribute any funds that were needed to protect their investment." (SPU-99-29, Tr. 338.)

In the Docket No. SPU-99-29 hearing, the Company was asked if it could provide options for the Company if there was a recession or if the revenues did not materialize as it anticipated. The witness responded by saying that the options would be for the equity investors to provide additional capital or find a third party to put in additional capital. (SPU-99-29, Tr. 375.) However, in this docket the Company has offered no evidence that it even sought additional common equity financing. (Ex. 201.) The Company's sworn testimony in 2000 is contradicted by its actions in 2002.

When other witnesses were asked what Iowa Telecom would do if it were in need of additional funds, the following options were identified: 1) Additional capital from the investors; 2) capital from a third party; 3) additional debt; or 4) reduce capital spending. Iowa Telecom never identified a rate increase as a possible source of additional revenue; instead, Iowa Telecom's witnesses testified that the Company's revenue projections at that time reflected no rate increases for four years. (SPU-99-29, Tr. 133-34, 300-01, 375.)

Now, after less than two years of operation, Iowa Telecom has come to the Board asking for a substantial rate increase. Nowhere in the proposal does Iowa Telecom state that it tried any of these other options first. When Consumer Advocate asked the Company about "additional funds" expected to be received by Iowa Telecom from its equity investors or other non-customer sources, Iowa Telecom responded, "[N]o such contributions are expected at this time." (Ex. 201.) The Board can only conclude that there is no financial assistance to be had at this time from either the existing investors or from a third party. It appears Iowa Telecom cannot afford to have any more debt in its capital structure. Finally, reducing capital spending will not allow Iowa Telecom to implement its network improvement plan costing $110 million. Thus, of the additional funding options that Iowa Telecom testified to in Docket No. SPU-99-29, it appears that just two years later none of them were available to the Company.

The Board agrees with Consumer Advocate that the increase in revenues from the proposed rate increase would not have a significant effect on Iowa Telecom's ability to attract capital on reasonable terms. Iowa Telecom's position is generally correct; when revenues are increased, the company's ability to attract capital improves. Unfortunately, in Iowa Telecom's case, it seems the rates would have to be even higher than Iowa Telecom's current proposals to have any real effect on attracting future capital. The residential rate proposed for year 2005 barely covers the interest cost of debt and the significant costs of preferred stock dividends, let alone the maintenance of the system and any improvements to the network. To increase retail rates in monopoly exchanges by an amount sufficient to support all these costs cannot be justified as reasonable.

5. Ability To Deploy Advanced Telecommunications Services

In its order issued in this docket on June 17, 2002, the Board directed Iowa Telecom to file a copy of its 2002 Network Improvement Plan in this docket. Iowa Telecom states the plan is intended as a road map for updating its existing network as well as the full deployment of advanced services. (Network Improvement Plan, p. 3.) Iowa Telecom estimates the cost of the plan at $110 million. Iowa Telecom states that implementation of the Network Improvement Plan depends on additional revenues generated by its proposal for a rate increase (Iowa Telecom Initial Brief, p. 16) and that the minimum length of time to complete the plan is six to eight years, based on the <u>non</u>-financial resources required to implement the plan. (Tr. 128.)

The record in this case contains several apparent inconsistencies in Iowa Telecom's testimony regarding capital expenditures used for the deployment of advanced services. Throughout this case, Iowa Telecom has claimed that one purpose of the proposed increase is to fund deployment of advanced telecommunications services. However, the record reveals that the proposed increases would be insufficient to cover Iowa Telecom's financing costs and make meaningful investments.

For example, in the Board's second request for additional information, Iowa Telecom was asked for a breakdown of the forecasted capital expenditures provided in the response to the Board's first request for additional information. Iowa Telecom provided its projected capital expenditures for the years 2002 through 2010 on a confidential basis. The Board then asked Iowa Telecom to detail how much money would go toward maintaining the existing network and how much would go toward major network improvements. Iowa Telecom responded that it did not segregate its capital expenditures into maintenance and major improvements, but if it were allowed to raise rates as proposed, the forecasted expenditures would be used for both. (Iowa Telecom, Second Submission of Additional Information, Response to Question # 13.) This makes it difficult to predict the amount of capital expenditures Iowa Telecom could or would invest annually in network improvements, but it makes it clear that any funds left over after the debt service would not be exclusively dedicated to deployment of advanced services. Instead, the leftover money would be spent on routine maintenance first, with only the leftovers of the leftovers available for advanced services.

In another example of the inconsistency of its position, at the Logan public comment hearing, Iowa Telecom's representative stated that if the proposed rate increase were approved, Iowa Telecom would commit, for at least the next three years, to use the money for improving the network. (Logan Public Comment Hearing, Tr. 12-13.) However, the same Company representative testified at hearing that the additional revenues generated from the rate increase will not be adequate to fund the Network Improvement Plan. (Tr. 42.) The Company never offered any explanation for this difference between the statements at the public comment hearing and the sworn testimony on the evidentiary record.

Throughout the public comment hearings in this docket, Iowa Telecom touted the deployment of advanced telecommunications services and network upgrades as the reason for asking for a rate increase. (See, for example, Newton Public Comment Hearing, Tr. 14.) However, Iowa Telecom's witnesses testified that because of Iowa Telecom's amended credit agreements, substantially all the Company's assets are pledged as collateral. (Tr. 225.) Also, Iowa Telecom's debt covenants require that it restrict capital expenditures and maintain certain maximum Senior and Total Leverage ratios, minimum Debt Service Coverage ratios, Interest Coverage ratios, and issuance of long-term debt. (Tr. 225-26.) These factors would severely limit Iowa Telecom's ability to deploy advanced telecommunications services even if the entire proposed rate increase were approved.

Finally, in Confidential Exhibit CAK-9, Iowa Telecom shows the projected use of proceeds from its proposed rate increase. While Iowa Telecom claims the projected expenditures are confidential, the Board notes that at the investment levels shown in the exhibit (which are almost certainly over-optimistic), it would take over 15 years, not 6 to 8 years, to complete the plan. Given the rate of technological change in the telecommunications industry, a 15-year plan to improve a network is really nothing more than a plan to build a network that will be out-of-date long before it is completed. If anything, Exhibit CAK-9 demonstrates the revenues from Iowa Telecom's proposed increases will not materially improve the Company's ability to deploy advanced telecommunications services.

The bottom line is this: Iowa Telecom has talked about investment in new, advanced services in trying to sell this case to the public, but the record evidence shows that this case is really all about debt and preferred stock payment, rather than advanced services. Most of the funds that would be obtained from the proposed increases would be used to pay capital costs, not for network improvements. (Ex. 20.) Iowa Telecom's financial obligations, which it assumed voluntarily when it purchased the Iowa assets of GTE, effectively preclude any significant deployment of advanced telecommunications services.

6. Conclusion

For all of these reasons, the Board rejects Iowa Telecom's proposed price increases, but accepts Iowa Telecom's proposal to consolidate its rates, albeit on a revenue-neutral basis only. In addition, the Board will approve a 3 percent increase in the consolidated rates, primarily to offset any costs the company may incur in consolidating its rates and also to address any incidental revenue losses that may result from rate consolidation.

Issue 2: Proposed Pricing Flexibility in Competitive Exchanges and Competitive Pricing Flexibility

Iowa Telecom asks that if the Board grants its proposed rate increases, it be permitted to leave rates unchanged in 33 of Iowa Telecom's exchanges where competitive local exchange carriers (CLECs) have overbuilt facilities.

The Board finds that Iowa Telecom's request is rendered moot by the Board's rejection of Iowa Telecom's proposed rate increases. The Board is approving a much smaller increase in Iowa Telecom's local rates to be implemented only after Iowa Telecom's rates are consolidated. There is no evidence in this record that an increase of only 3 percent will justify freezing rates in the competitive exchanges, and the Board will, therefore, reject Iowa Telecom's proposal to freeze those rates.

Iowa Telecom also asks that the Board grant it the same BCS pricing flexibility in competitive exchanges that the Board previously approved in the price plans of Qwest Corporation and Frontier Communications, Inc. The proposed language would provide:

> Iowa Telecom can decrease any BCS rate in a particular exchange or exchanges to a level that exceeds costs to respond to competition. Under no circumstances will an exchange-by-exchange rate reduction for BCS service result in increases in BCS rates for other exchanges, nor shall it reduce the amount of reduction otherwise applicable for other exchanges. Any decrease in BCS rates on an exchange-by exchange basis may be used to offset any annual deflation decrease, which would otherwise be applicable for a given exchange.

Iowa Telecom states that it needs to be able to meet competitors' local prices in order to compete in these markets and needs the flexibility to set prices on an exchange-by-exchange basis. (Tr. 175, 384.) Iowa Telecom would agree to abide by the same limitations that the Board applied to Qwest when approving the same provision. Those limitations include a showing that there is sufficient competition and that the reduced rate is above cost.

In support of its request, Iowa Telecom points to the Board's April 5, 2002, order in Docket No. INU-01-1, "Order Denying Petition for Deregulation," pp. 20-21, where the Board suggested that Iowa Telecom could adopt competitive response language similar to the provisions the Board had already approved. (Iowa Telecom, Reply Brief, p. 25, 26)

Consumer Advocate argues that the requirement stating "Under no circumstances will an exchange-by-exchange rate reduction of a BCS service result in increases in BCS rates for other exchanges, nor shall it reduce the amount of reduction otherwise applicable for other exchanges" is not enforceable with respect to Iowa Telecom. Consumer Advocate argues that in the case of Qwest and Frontier, this requirement explicitly prohibits discrimination in favor of customers who have at least one alternative local exchange carrier, because any BCS price increases by Qwest and Frontier in the non-competitive exchanges are explicitly capped by the inflation measure and productivity factor offset of Iowa Code § 476.97(3)"a"(5) (2001). (Tr. 449-50.)

In contrast, § 3 of Senate File 429 permits Iowa Telecom to propose BCS price increases once every three years without any defined, measurable cap. As a result, if the competitive response language is approved, Iowa Telecom would have the unique ability to raise rates in non-competitive exchanges to make up for any revenues lost in the competitive exchanges. Consumer Advocate argues that this makes the provision quoted above unenforceable.

IAMU presented testimony that Iowa Telecom's request for sharply lower rates in 35 of the Company's 296 exchanges is not supported by adequate evidence of effective competition in the 35 exchanges. IAMU contends that the concerns of the

Board in the Iowa Telecom deregulation case, Docket No. INU-01-1, relating to damage to small competitors by a large incumbent local exchange carrier (ILEC) engaging in predatory practices had not been addressed by Iowa Telecom. (IAMU, Initial Brief, pp. 6, 9.) IAMU asserts that Iowa Telecom's plan to cross-subsidize low rates in exchanges with CLECs from higher rates in monopoly exchanges is contrary to both statute and Board policy.

The Municipal CLECs assert that even without the benefit of the confidential documents, it is plain that Iowa Telecom's basic problem is it paid too much for a system that its own witness characterized as "outdated technology." (Tr. 732.) The Municipal CLECs argue that "any exchange-by-exchange reduction should only be allowed where they make economic sense, and not to support bad business decisions through the use of monopoly power underpinning predatory pricing to destroy alternative providers." (Municipal CLECs, Initial Brief, p. 6.)

The Board will approve Iowa Telecom's request to add BCS pricing flexibility to its price regulation scheme.[12] No changes will take place without an opportunity for Board review, and the Board is confident that with the help of the interested parties, it will be able to prevent any anticompetitive abuse of this provision. This docket has demonstrated the difficulties associated with these competitive-response pricing flexibility provisions, difficulties that include defining terms such as "costs,"

[12] Because Iowa Telecom does not have a specific price regulation plan on file with the Board, the language should be added to Iowa Telecom's tariff.

preventing predatory pricing, and related issues. Issues such as these can be addressed in a future proceeding, if and when necessary.

CONCLUSION OF LAW

The Board has jurisdiction of this matter pursuant to Iowa Code §§ 476.1 and 476.97(11)"h" (2002).

FINDINGS OF FACT

1. The rates Iowa Telecom has proposed in the filings identified as TF-02-225, TF-02-226, and TF-02-227 are not shown, on this record, to be reasonable. Iowa Telecom proposes to make its customers pay for its own mistakes. The Board rejects that proposal.

2. Iowa Telecom has shown that there would be substantial benefit to the public and the Company from consolidating its various rates. The Board finds it reasonable to consolidate rates in all exchanges in a revenue-neutral manner and to allow Iowa Telecom a 3 percent increase in the consolidated rates to help defray the costs of rate consolidation. In making this finding, the Board specifically relies on the provisions of Iowa Code §§ 476.95(3) and 476.97(11)"h"(1), which require moving prices for telecommunications services toward cost and consideration of rate consolidation in price regulation plan modification proceedings such as this one.

3. The impact on Iowa Telecom of competition and other external factors does not justify Iowa Telecom's proposed price increases.

4. Iowa Telecom's proposed price increases would not have a significant effect on Iowa Telecom's ability to attract capital.

5. Iowa Telecom's proposed price increases would not have a significant effect on Iowa Telecom's ability to deploy advanced telecommunications services.

6. Iowa Telecom's proposal to freeze rates in exchanges where a CLEC also provides service, while increasing rates in monopoly exchanges, is moot.

7. Iowa Telecom's proposal to add a pricing flexibility provision to its price regulation requirements is reasonable and should be approved.

ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The proposed tariffs filed by Iowa Telecom on May 24, 2002, identified as TF-02-225, TF-02-226, and TF-02-227, are rejected because the rates proposed therein are unreasonable.

2. Within 30 days of the date of this order, Iowa Telecom shall file proposed tariff sheets for a revenue-neutral rate consolidation of all rates that currently differ among the rate zones (other than Extended Area Service rates or similar exchange-based rates), with all supporting workpapers. The tariffs should reflect a 3 percent revenue increase for consolidated rates and a 1.06 percent price adjustment for all BCS prices. The calculations should first be performed without the 3 percent revenue increase for the consolidated rates or the 1.06 percent increase for BCS prices, which should then be added as successive calculations.

3. Within 30 days of the date of this order, Iowa Telecom shall file proposed tariff sheets adding its proposed competitive-response pricing flexibility language to its price regulation requirements.

4. Within 45 days of the date of this order, Iowa Telecom shall file a proposed refund plan complying with the requirements of Iowa Code § 476.97(11)"h" and the Board's decision herein.

5. Motions and objections not previously granted or sustained are denied or overruled. Any argument in the briefs not specifically addressed in this order is rejected either as not supported by the evidence or as not being of sufficient persuasiveness to warrant comments.

UTILITIES BOARD

/s/ Mark O. Lambert

/s/ Elliott Smith

CONCURRENCE AND DISSENT OF DIANE MUNNS, CHAIR

I concur in the majority's decision with respect to rate consolidation and the flexible pricing provision. I dissent from that part of the majority's decision that grants Iowa Telecom a three percent increase in the consolidated rates. While I agree that the plan formulated by my colleagues appears reasonable, it does nothing to solve the real problem presented in this docket, Iowa Telecom's obligations for financing costs. Any solution must be a combined effort among investors, creditors, and ratepayers. The burden of the Company's financial situation cannot be entirely shifted to or borne by ratepayers. Until there is some recognition of this joint responsibility for the success of the Company and a plan to place the Company on a firm financial footing, I would not grant any relief.

/s/ Diane Munns

ATTEST:

/s/ Sharon Mayer
Executive Secretary, Assistant to

Dated at Des Moines, Iowa, this 26th day of December, 2002.